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SUBJECT: MOROCCO MOVES GINGERLY TOWARDS FOREIGN EXCHANGE LIBERALIZATION

¶1. Sensitive but unclassified - entire text. Please handle accordingly.

¶2. (SBU) Summary: A series of new circulars issued by Morocco's Office des Changes this fall represents further intensification of preparations for the country's medium term goal of transitioning to a freely floating exchange rate. Central Bank and government officials speak officially of a three year transition period, but privately tell us that they hope that the change can occur more rapidly, given difficulties in managing the current fixed or basket peg. Exporters have clamored for the change, citing competitive problems that have resulted from the dirham's appreciation against the dollar and currencies in the region (given the weight of the Euro in the currency basket). The IMF, however, concluded earlier this year that "the dirham is not misaligned." End Summary.

¶3. (U) Morocco is currently one of only 9 countries that applies a basket peg exchange rate mechanism. Its current exchange regime dates to April 2001, when the basket to which the dirham is pegged was adjusted away from the dollar in favor of the Euro. The move reflected the country's increasing economic integration with the European Union, and followed a decade in which the dirham appreciated by 21 percent in real terms because of the dollar's then strength. The shift brought an immediate five percent devaluation in the dirham. The peg has worked well since that time, and the dirham has not come under pressure recently, as evidenced by the country's relatively low real interest rates and healthy official reserves (which currently represent nearly a year of imports). Those reserves have grown steadily despite the country's structural trade deficit, thanks to transfers from Moroccans abroad, tourism, and burgeoning foreign direct investment. Central Bank officials indicate, however, that the peg has at times been "difficult" to manage, and that complications could increase as the country pursues further capital account liberalization.

¶4. (U) The most frequent complaint about the current system stems from the fact that as the Euro has appreciated against the dollar, it has pulled the dirham along in its wake. The IMF concluded this year in its Article IV consulations with the Moroccan government that the "dirham is not misaligned," but exporters have not agreed. They point to the fact that since 2001 while the dirham has depreciated by 9 percent against the Euro, it has appreciated by some 28 percent against the U.S. dollar. This has also entailed significant appreciation against other competing currencies in the

region, including those in Tunisia and Egypt. Casablanca market analysts are reluctant to give a figure to the impact, but concur that the change has undoubtedly slowed the country's export growth. Though Morocco has continued to run a current account surplus in recent years thanks to tourism, transfers and investments, analysts have sounded the alarm at the fact that exports now cover only 48 percent of imports.

¶5. (SBU) A recent study by Morocco's leading bank, Attijarawafa, highlights the fact that Morocco is at the crossroads between a fully flexible system and its current peg. The current system, the bank concludes, is best adapted to small countries with open economies that are "insulated" from external influences and have the ability to deal with temporary shocks through fiscal policy. In contrast, the bank argues, a flexible exchange rate is best suited for large well-integrated economies that have significant trade flows and strong labor mobility. Morocco, in the view of Attijarawafa is precisely in midstream, having graduated from the former category thanks to its policy of trade liberalization and openness to international commerce (which now constitutes 55 percent of GDP), but it is not yet in the latter category, given the small size of its economy and the weakness of its labor market. As a result, Chakib Erquizi, Director of Market Activities argued to us in a recent meeting, Morocco is in need of three to five years of reforms to put in place the mechanisms that will permit it to successfully implement a floating or flexible rate.

¶6. (SBU) Houssam Barakat, who handles exchange transactions at rival BMCE Capital, concurs that the moment is approaching for Morocco to begin the move to a more flexible monetary policy. The current system, he told us, has ensured stability vis-a-vis Morocco's principal European partners, and has also minimized currency risk for foreign investors, contributing to their confidence in the Moroccan economy.

For Moroccan markets to take the next step, however, the country should graduate to a a floating regime. Both Erquizi and Barakat believe that market sophistication has greatly improved since the foreign exchange market was launched in Morocco in 1996. They note the existence of varied instruments including swaps and options that were not present at that early date. The continued increase in Morocco's currency reserves, in their view, also demonstrates the country's readiness for the transition. What is lacking, they argue, is a "culture of risk" and full understanding by Moroccan market players of the range of international options open to them. In their view, however, the new measures announced by the Ministry of Finance and its Office des Changes in August open the door to significant progress in these areas.

¶7. (U) Those measures, contained in eight circulars, include significant new measures to further liberalize Morocco's capital account. Among them are a reduction in the surrender requirement on export proceeds, partial liberalization of trade-related credits and payments, expansion of the range of transactions that can be covered by currency hedging instruments (together with lengthened maturities for such instruments), and partial liberalization of portfolio investment by securities firms, insurance companies and mutual funds. Foreign direct investment by firms and Moroccan residents was also liberalized. The measures are in line with recommendations by IMF staff, and aim at helping market players develop the savoir faire that will enable them to compete and prosper in a fully globalized marketplace. In remarks in early August, Morocco's alternative Executive Director at the IMF characterized the measures as "important additional steps" on the road toward capital account convertability, which should encourage more efficient use of resources and risk diversification, while facilitating the task of liquidity management," thereby helping assure continued control of inflation.

¶8. (SBU) The new rules are not the only significant change in Morocco's foreign exchange regime. Central Bank Governor

Jouahri also earlier this year lifted the veil of secrecy that surrounded the exact composition of the dirham basket, revealing that the relative weight is 80 percent for the Euro and 20 percent for the dollar. Specialists had earlier roughly determined this by modeling the currency, but public confirmation brought a welcome dose of transparency to the system. Morocco also signed a "Master Derivatives Agreement" with the World Bank to help it hedge currency risks related to its external debt.

¶9. (SBU) Attijarawafa's Erquizi predicted to us that the new measures announced by the Office des Changes will have a positive impact on overall market dynamics in Morocco, as currently "the yield curve doesn't fully reflect the economy." Instead, liquidity has been trapped in the Moroccan economy, keeping interest rates down and leading to inflated prices for assets that "sometimes do not reflect fundamentals." He pointed particularly to several IPO's on the Casablanca Stock Exchange, which have dramatically appreciated since their launch. (Overall, the Casablanca exchange has been one of the best performing in the region, rising 70 percent in 2006 and a further 40 percent this year, despite a brief correction in May.) The impact of the current system on Moroccan real estate, he said, has been similar. If the market were not closed, he argued, investors would have other assets abroad, and prices would be more in line with the Moroccan economy's underlying fundamentals. The new rules, he said, should start to begin this transition. Barakat cautioned, however, that this will not happen overnight, given the extremely high profits that investors have realized from Moroccan assets in recent years.

¶10. (SBU) Erquizi noted that deepening of capital makets and greater investment bank expertise are nt all that Morocco needs, however. In his view,further structural reforms in the Moroccan econoy are necessary as well. These include particularly reform of the Moroccan labor market to provide for added "flexibility of employment." Erquizi greed with the point that Treasury Director Geneal Chorfi and others have made in public that a iberal regime does not necessarily imply a devaluation of the dirham, given that demand has exceedd supply for the last five years. He cautioned,however, that this may not be the case once locals have greater opportunity to place their assets aroad.

¶11. (SBU) Comment: Change is coming to Morocco's foreign exchange markets, and while full liberalization is still some distance away, experts concur that the changes announced this fall represent a dramatic break with the past and clear evidence of the seriousness of Moroccan plans to move to a floating rate. How fast the change occurs will depend on the success of these initial reforms and how adept Moroccan traders are at exploiting them. Historically Morocco has preferred to adopt a gradual approach in this sensitive area, however, so the transition is likely to be longer rather than shorter. End comment.

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